No. 51

In the Supreme Court of the United States

October Term, 1952

F. Donald Arrowsmith and Ruth R. Bauer, Executors of the Last Will and Testament of Frederick R. Bauer, Deceased, and Ruth R. Bauer, *et al.*,

Petitioners

v.

Commissioner of Internal Revenue

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the Tax Court (R. 4-8) is reported at 15 T. C. 876. The opinion of the Court of Appeals (R. 19-20) is reported at 193 F. 2d 734.

JURISDICTION

The judgments of the Court of Appeals were entered January 10, 1952. (R. 21-22.) A petition for rehearing was denied February 11, 1952. (R. 24.) The petition for a writ of certiorari was filed May 6, 1952, and was granted June 9, 1952. (R. 25.) The jurisdiction of this Court rests on 28 U. S. C., Section 1254.

QUESTIONS PRESENTED

The taxpayers Bauer and Pogue liquidated a corporation of which they were the sole and equal stockholders, and reported the gain from the exchange of their stock for the corporate assets as a long-term capital gain. In a subsequent year they refunded a portion of the amount received on the liquidation, in satisfaction of their transferee liability for a corporate debt. The questions presented are:

1. Was the amount refunded fully deductible as an ordinary loss under Section 23(e) of the Internal Revenue Code, or only in part as a capital loss under Sections 23(g) and 117?

2. As to Bauer, must his share of the refund in any event be treated as an ordinary loss because the creditor obtained a judgment against him as well as against the corporation?

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*, pp. 44-49.

STATEMENT

The facts as stipulated (R. 16-18) were adopted by the Tax Court as its findings (R. 4-6). They may be summarized as follows:

Petitioners are the successors in interest of Frederick R. Bauer and Davenport Pogue, each of whom owned one-half of the stock of Bauer, Pogue and Company, Inc. (hereafter called the "corporation"). (R. 4-5.) For convenience the term "taxpayer" will be used to denote the original stockholders, Bauer and Pogue.[1]

During the years 1937 to 1940, inclusive, the corporation made a series of liquidation distributions which resulted in its complete liquidation. (R. 5.) In their income tax returns for those years taxpayers reported the distributions as capital gains. (R. 6; Stip. Exs. 3-C, 4-D, 5-E.)[2]

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[1] Pogue died in 1937, and his stock was transferred to his executor and thence to his heir and widow, the petitioner, Mary S. Vivian. Bauer died after the commencement of these proceedings, and is now represented by his executors. Ruth R. Bauer is a petitioner individually because she and her husband filed a joint return for the taxable year. (R. 4-5.)

[2] In each of the years 1938, 1939 and 1940 Bauer reported fifty percent of the gains as long-term capital gains, and for 1937 he reported forty percent. (Ex. 3-C.) Pogue's estate did not report any distribution in its 1937 return (R. 5), and in its 1938 return it reported a short-term capital loss from the distribution (Ex. 4-D). In her 1939 return Vivian reported fifty percent of the gain as a long-term capital gain, and in her 1940 return she reported a long-term capital loss. (Ex. 5-E.) By stipulation of the parties the exhibits to the stipulation of facts have not been printed, but have been transmitted to the Clerk of this Court. (R. 25.)

In 1939, while the liquidation was in process, an action was commenced against the corporation and its stockholders. The action resulted in a judgment against the corporation and against Bauer personally, which was subsequently affirmed on appeal. *Trounstine* v. *Bauer, Pogue & Co.,* 44 F. Supp. 767 (S. D. N. Y.), affirmed, 144 F. 2d 379 (C. A. 2d), certiorari denied, 323 U. S. 777. In 1944, after the judgment became final, each of the taxpayers was required to and did pay one-half of the judgment, or $47,963.25, which amount was less than the liquidation distributions each had received from the corporation. (R. 5-6.) The payments were made in satisfaction of their liability as transferees of the corporate assets. (R. 4, 6.)

In their respective income tax returns for 1944 each of the taxpayers deducted in full as an ordinary loss the amount paid to the judgment creditor of the corporation. The Commissioner determined that the payments represented capital losses, deductible only in part. (R. 6, 13-15.) The Tax Court regarded this case as indistinguishable from *Switlik* v. *Commissioner,* 13 T. C. 121, affirmed, 184 F. 2d 299 (C. A. 3d), and on the basis of its decision in that case held that the payments were deductible as ordinary losses. (R. 6-8.) [3]

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[3] In the *Switlik* case the Tax Court held that post-liquidation payments of a corporate tax indebtedness by stockholders in satisfaction of their transferee liability were deductible as ordinary rather than as capital losses, on the ground that the payments were made in a taxable year subsequent to their receipt of the corporate assets.

The Court of Appeals reversed, holding that the payments were deductible as capital losses. (R. 19-20.)

SUMMARY OF ARGUMENT

I

Section 23(g) of the Internal Revenue Code limits the deduction of losses otherwise allowable under Section 23(e), by providing that losses from sales or exchanges of capital assets (capital losses) are deductible only to the extent allowed in Section 117. The latter section prescribes that only fifty percent of a long-term capital gain or loss shall be taken into account in computing net income. Gains or losses realized by a stockholder from a corporate liquidation are made subject to the capital gain and loss limitations by Section 115(c), which requires that the liquidation distributions be treated as amounts received "in exchange" for the stock.

The court below correctly held that the taxpayers, who realized capital gains upon the liquidation of a corporation of which they were the equal stockholders, sustained capital losses subject to the limitations of Sections 23(g) and 117—not ordinary losses deductible in full under Section 23(e)—when in a later year they refunded a portion of the liquidation proceeds to a judgment creditor of the corporation in satisfaction of their liability as transferees of the corporate assets. The liquida-

tion distributions represented amounts received by taxpayers in exchange for their stock, a capital asset, and resulted in long-term capital gains only a percentage of which they reported in their income tax returns for the years in which the distributions were received. Their transferee liability for the corporate debt flowed solely and directly from, and was an integral part of, the transfer of the corporate assets in exchange for their stock. Their payments in discharge of that liability merely reduced the capital distributions received from the corporation and, correspondingly, the long-term capital gain realized therefrom. The same capital transaction which gave rise to the previously reported capital gain—exchange of stock for corporate assets—also produced the loss in question. That loss, like the previously reported capital gain, resulted "from" the exchange within the meaning of Section 23(g); and that transaction was just as much a capital transaction for purposes of determining the taxpayers' loss as it was for determining their gain.

To treat the post-liquidation payment of a corporate debt by a transferee-stockholder as an ordinary loss deductible in full under Section 23(e) would not only defeat the express limitations of Section 23(g) on capital loss deductions; it would in effect relieve the stockholder of tax on more than fifty percent of the actual gain realized from the exchange of his stock for the corporate assets,

contrary to the mandate of Section 117, by permitting him to deduct one hundred percent of the assets used to satisfy the debt after having taken into account only fifty percent of those assets in computing the capital gain on the exchange. This would open the door to a ready means of tax avoidance by stockholders of a closely held corporation whose assets are subject to outstanding or contingent liabilities at the time of liquidation, especially where as here the stockholders are aware of such liabilities when they receive the corporate assets.

The Tax Court treated the payments as ordinary losses on the theory that, having been made in a taxable year subsequent to the liquidation exchange, the "annual accounting" rule served to sever the connection between the transfer of the corporate assets to the stockholders and their transferee liability for the corporate debts. Nothing in the statute or the decisions warrants such an application of the annual accounting rule, and the court below properly rejected it. The annual accounting concept has reference to *when* an income or deduction item must be accounted for in computing net income, not to whether or to what extent the item enters into the computation. While it prevents the reopening of a past year's tax return in order to reflect subsequent events, it does not preclude examination of past events for purposes of determining the nature and tax effect of a

payment in the current year. Indeed, to disassociate a payment from the underlying transaction which created the liability to pay, merely because the transaction had its inception in an earlier year, would foreclose any inquiry as to the character and deductibility of the payment. Where stockholders receive liquidation distributions in successive years the courts have treated the distributions as interrelated steps of a single capital transaction, resulting in additional capital gain in the later years; conversely, where as here a part of the amount received is surrendered by the stockholders in a later year in discharge of their transferee liability, the portion refunded represents a diminution of the prior capital distributions and is deductible as a capital loss. Had taxpayers made the payments in the same taxable year in which the liquidation distributions were received and reported as long-term capital gains, the payments unquestionably would be deductible as capital losses in that year. They are not transformed into ordinary losses simply because they were made, and are deductible, in a later year.

Taxpayers' contention that the court below disregarded the Tax Court's findings in holding that the payments resulted from the liquidation exchange misconceives the rationale of the Tax Court's decision. The Tax Court recognized that the transferee liability which occasioned the payments arose from the exchange, but erroneously

considered itself precluded as a matter of law—by reason of the annual accounting rule—from relating the transferee liability to the earlier year's exchange.

If the payments are completely disassociated from the prior liquidation exchange, as taxpayers contend, there would seem to be no escape from the paradoxical conclusion, hardly desired by the taxpayers, that no deduction whatsoever could be taken for these losses. Section 23(e) authorizes the deduction of losses incurred in a "transaction entered into for profit", and the only transaction which the record and findings disclose as having created the transferee liability discharged by the payments was the liquidation of the corporation, concededly a capital transaction. Unless the payments are related to that transaction and with the resultant transferee liability, they are not deductible either as capital or ordinary losses.

II

Bauer's payment of one-half of the corporate debt did not differ in nature from Pogue's payment of the other half merely because the creditor obtained a judgment against him personally as well as the corporation. The judgment was obtained in an action brought against the corporation for an accounting of profits realized from a joint venture entered into by the corporation and the plaintiff. Bauer and Pogue were made parties defendant as stockholder-transferees of the corporation and as officers who had mismanaged its af-

fairs; only Bauer was served, however, and he was held jointly liable with the corporation. By paying one-half of the judgment Bauer satisfied his transferee liability as a stockholder, not his tort liability as an officer, and the Tax Court so viewed his payment. Moreover, were Bauer's payment of half of the amount of the judgment viewed as a partial satisfaction of his tort liability for mismanagement of the corporation, it would not be a deductible loss at all. At any rate, as the court below pointed out, Bauer's payment served to extinguish his pro rata transferee liability as a stockholder, and for tax purposes can stand on no different footing from Pogue's payment. Since both courts below regarded Bauer's payment of half of the judgment, like Pogue's payment of the other half, as made in satisfaction of transferee liability, if this Court should take a different view, the case should be remanded for a determination of the nature and deductibility of Bauer's payment.

ARGUMENT

I

The Claimed Deductions Are Allowable as Capital Losses Under Section 23(g) and 117 of the Internal Revenue Code, Not as Ordinary Losses Under Section 23(e)

A. Introductory

These cases present a single question of law arising from an agreed set of facts: Whether a stock-

holder who realizes a capital gain [4] from the exchange of his stock for the corporate assets upon liquidation of the corporation, and in a later year refunds a portion of the liquidation proceeds to a creditor of the corporation in satisfaction of his transferee liability, may deduct the refund payment in full as an ordinary loss under Section 23(e) of the Internal Revenue Code (Appendix, *infra*, p. 44), or is required to treat it as a capital loss deductible only to the extent provided in Sections 23(g) and 117 (Appendix, *infra*, pp. 44, 46-47). Each of the taxpayers made a capital investment represented by one-half of the shares of stock in a corporation. During the years 1937 to 1940, they liquidated the corporation and, pursuant to the provisions of Sections 115(c) (Appendix, *infra*, p. 45) and 117(a) and (b) of the Internal Revenue Code and similar provisions of prior Acts, each reported his gain from the liquidation distributions as long-term capital gain, taking into account only a percentage [5] of the gain in computing his net income. At the time the corporation was liquidated its assets were subject to a contingent liability, of which the taxpayers were aware, and this liability

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[4] See fn. 2, *supra*, p. 3, where it is shown that in the two years 1938 and 1940 one of the stockholders (Pogue and his successor in interest, Vivian) reported a capital loss. However, whether a capital gain or loss is reported, the basic question is the same.

[5] See footnote 2, *supra*.

became absolute in 1944 when a judgment against the corporation became final.[6] In that year taxpayers restored a portion of the liquidation proceeds to the judgment creditor, each paying one-half of the judgment in satisfaction of his pro rata liability as a transferee of the corporate assets. In their income tax returns for 1944 each sought to deduct his payment in full as an ordinary loss under Section 23(e). The Commissioner ruled that the payments were deductible as long-term capital losses under Sections 23(g) and 117(b), only fifty percent of which could be taken into account. (R. 4-6, 13-15; Stip. Exs. 1-A to 5-E.)

Viewing this case as "not distinguishable" from *Switlik* v. *Commissioner,* 13 T. C. 121, affirmed, 184 F. 2d 299 (C. A. 3d), the Tax Court overruled the Commissioner's determination. (R. 8.) In the *Switlik* case the Tax Court held that stockholders who had reported long-term capital gains on the liquidation of a corporation in 1941, and in 1944 paid tax deficiencies of the corporation in satisfaction of their transferee liability, could deduct the full amount of the payment in 1944 as an ordinary loss. It reasoned as follows (13 T. C., at pp. 126-127): (1) Under our system of computing net income by annual accounting periods, each taxable year is a separate unit for tax accounting purposes;

[6] The suit which culminated in the judgment against the corporation was commenced in 1939, and the liquidation was completed in 1940. (R. 5.)

(2) the liquidation distributions were received and properly reported as long-term capital gains in 1941, while the refund payments in satisfaction of transferee liability were made and properly reported as losses in 1944; (3) therefore, the 1944 losses were ordinary rather than capital losses, "and this is true even though the transferee liability which occasioned the losses arose out of distributions which resulted in capital gains in 1941". The Court of Appeals for the Third Circuit approved this reasoning in affirming the Tax Court's decision in the *Switlik* case. 184 F. 2d 299. The court below, however, while agreeing with the major and minor premises of the syllogism, did not think that the conclusion drawn by the Tax Court was either necessary or justified. (R. 19-20.)

We think the Court of Appeals for the Second Circuit is clearly correct in its analysis of this problem. Agreeing with the dissenting opinion in the *Switlik* case (13 T. C., at pp. 127-128), the court below held that the annual accounting rule does not preclude an examination of transactions or events occurring in a prior year for purposes of determining the *nature* and tax effect of a payment made in a later year; that the payments which taxpayers here made in 1944 and are seeking to deduct as ordinary losses in that year "were directly related to" and "tied together" with the liquidation distributions they reported as long-term capital gains in prior years, and represent merely

"diminution" of those gains; and that "considering together the events of the previous year and of the taxable year, the loss in the taxable year shows up as arising out of a 'sale or exchange' ", and hence is deductible as a capital loss. (R. 19-20.)

The taxpayers take the position that the court below erred in relating their transferee liability to the liquidation distributions for purposes of determining whether the payments in satisfaction of that liability represented ordinary or capital losses. They look upon the annual accounting rule as if it required that each tax year must be examined *in vacuo,* like an airtight compartment, and as if it bore no relation whatsoever to events occurring in other tax years. But business transactions carrying tax consequences do not necessarily, or even ordinarily, begin and end within a single tax year. And the court below was plainly right in holding that the annual accounting rule does not mean that in determining whether a transaction gives rise to capital gain or loss in one year, no inquiry can be made as to how the same transaction was treated by the taxpayer and the Commissioner in earlier years.

B. The Relevant Statutory Provisions

Section 115(c) of the Internal Revenue Code provides that "Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock" and that

the "gain or loss to the distributee resulting from such exchange shall be determined under section 111". Under the latter section (Appendix, *infra*, p. 45) the gain or loss from the exchange is the difference between the "amount realized" and the "adjusted basis" of the stock;[7] and the "amount realized" is the sum of any money received plus the fair market value of any property received. Section 117 deals specifically with "Capital Gains and Losses".[8] Section 117(a)(1) defines a "Capital Asset" as including property held by the taxpayer whether or not connected with his business, with exceptions not pertinent here; and Section 117(a)(4) and (5) defines a gain or loss "from the sale or exchange of a capital asset held for more than 6 months" as a "long-term" capital gain or loss. Section 117(b) prescribes that only fifty percent of a long-term capital gain or loss is to be taken into account in computing net income, and Section 117(d) allows capital loss deductions only to the extent of capital gains with exceptions not

[7] The "basis" of the stock is its "cost" (Section 113(a)), "adjusted" in accordance with the provisions of Section 113(b).

[8] Capital gains and losses, *i.e.*, those resulting from the sale or exchange of a capital asset were first accorded special treatment in Section 206 of the Revenue Act of 1921, c. 136, 42 Stat. 227. See H. Rep. No. 350, 67th Cong., 1st Sess., p. 10 (1939-1 Cum. Bull. (Part 2) 168, 176; S. Rep. No. 275, 67th Cong., 1st Sess., p. 12 (1939-1 Cum. Bull. (Part 2) 181, 189. With various modifications, the special treatment of such gains has been a feature of every subsequent Revenue Act.

here material.[9] It is now settled that in requiring liquidation distributions by a corporation to be treated as amounts paid "in exchange" for the stock (Section 115(c)), Congress intended to subject stockholders' gains or losses from corporate liquidations to the statutory conditions and limitations imposed upon capital gains or losses. *White* v. *United States,* 305 U. S. 281; *Helvering* v. *Weaver Co.,* 305 U. S. 293. See also Section 29.115-5 of Treasury Regulations 111 (Appendix, *infra,* pp. 48-49).

Section 23(e)(2) of the Internal Revenue Code authorizes a deduction from gross income of losses sustained during the taxable year, though not connected with the taxpayer's business, "if incurred in any transaction entered into for profit". The deduction authorized by this section is limited, however, by Section 23(g), which provides that "Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117". See also Sections 29.23(e)-1, 29.23(g)-1 and 29.117-2 of Treasury Regulations 111 (Appendix, *infra,* pp. 47, 48, 49). A loss which qualifies for deduction in full under Section 23(e) is an ordinary loss, as distinguished from a capital loss which is subject to the limitations of Sections 23(g) and 117.

[9] Section 117(c) provides for an alternative tax on the excess of net long-term capital gain over net short-term capital loss.

Whether a payment qualifies for deduction as either an ordinary or a capital loss [10] necessarily depends upon the nature of the liability which it extinguishes, which in turn depends upon the nature of the "transaction" from which the liability flows. If the liability is incurred in a "transaction entered into for profit" other than a capital transaction, the payment is deductible as an ordinary loss under Section 23(e). On the other hand, if the transaction which creates the liability is a sale or exchange of a capital asset—a capital transaction—the express limitations of Sections 23(g) and 117 come into play.

C. Taxpayers' Transferee Liability for the Corporate Debt Having Resulted Solely from the Liquidation Exchange of Their Stock for the Corporate Assets (a Capital Transaction), Their Payments in Satisfaction of That Liability Were Capital Losses

Since the liquidation distributions received by taxpayers constitued amounts received in exchange for their stock by virtue of the provisions of Section 115(c), the gains realized from that exchange constituted long-term capital gains taxable only to

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[10] The provisions of Section 23(e) and (g) must of course be examined in the light of the "now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer". *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590, 593. See also *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440; *Deputy* v. *duPont*, 308 U. S. 488, 493; *Boehm* v. *Commissioner*, 326 U. S. 287, 295.

the extent provided in Section 117.[11] Taxpayers so treated the transaction by reporting only a percentage of the gains in their income tax returns for the years in which the liquidation distributions were received. (Stip. Exs. 3-C, 4-D and 5-E.) The losses which they now seek to deduct—amounts refunded to a creditor of the corporation in discharge of their liability as transferees of the corporate assets—resulted solely and directly from the prior exchange and are no less capital in nature than the previously reported gains. The same capital transaction which produced the gains also produced the loss, and as in the case of the previously reported gains only, a percentage of the loss may be taken into account under Section 117(b).

When the assets of a corporation are distributed to its stockholders in liquidation, they are received subject to the corporate liabilities, existing and potential. If the transferee-stockholders do not expressly assume the corporate debts, they are by operation of law obliged to satisfy them. It has long been settled that "if the assets of a corporation are distributed among the stockholders before all its debts are paid, each stockholder is liable severally to creditors, to the extent of the amount received by him; and that as between all stockholders similarly situated the burden of paying the debts shall be borne ratably". *Phillips-Jones Corp.*

[11] The stock admittedly constituted a "capital asset" as defined in Section 117(a)(1) and had been held for more than six months.

v. *Parmley*, 302 U. S. 233, 235-236. See also *Pierce v. United States*, 255 U. S. 398, 402-403.[12]

Both courts below properly viewed the payments here involved as discharging a transferee liability which the taxpayers incurred as a result of the exchange of their stock for the corporate assets. The payments were made in proportion to their former stock holdings, to a judgment creditor of the corporation. As the Tax Court observed, each of the taxpayers "was required to, and did, pay one-half of the judgment" (R. 6), against "a corporation of which they were transferees" (R. 6, 8). And in the words of the court below, the liability was "directly related to—and would not have existed except for—the capital distributions made by the corporation to those taxpayers in earlier years".[13] (R. 19.)

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[12] The law of the state (New York) in which the instant corporation carried on its business is in accord with this rule. *Bartlett* v. *Drew*, 57 N. Y. 587, 589; *Hastings* v. *Drew*, 76 N. Y. 9, 16; *Hazard* v. *Wight*, 201 N. Y. 399, 402-403. See also New York Stock Corporation Law, Secs. 15, 58, 58 McKinney's Consolidated Laws of New York, Annotated; New York Debtor and Creditor Law, Sec. 273, 12 McKinney's Consolidated Laws of New York, Annotated. Section 311(a) of the Internal Revenue Code provides a summary method whereby taxes imposed on a liquidated corporation may be collected from the transferee stockholders. *Phillips* v. *Commissioner*, 283 U. S. 589.

[13] Taxpayers' contention (Br. 9) that the court below disregarded the Tax Court's findings in relating the payments to the liquidation exchange arises from a misconception of the Tax Court's decision. The Tax Court here (R. 8) rested its

Since the liability which occasioned the payments arose from a capital transaction, the receipt of corporate assets subject to the liability in exchange for stock, the payments in satisfaction of that liability represent losses arising from an exchange and are subject to the capital loss limitations.[14] To hold that such payments are deductible as ordinary losses would defeat the express command in Section 23(g) that losses arising "from"

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decision on its reasoning in the *Switlik* case, *supra*, where it expressly recognized that the payments discharged a transferee liability resulting from the exchange, but considered itself foreclosed by the "annual accounting" rule from relating the payments to the exchange because they were made in a subsequent taxable year. As will be shown (pp. 27-36, *infra*) the Tax Court misapplied the annual accounting rule. Suffice it to note now that the court below did not disagree with any of the Tax Court's findings, which consist of a restatement of the stipulated facts. It merely dispelled the Tax Court's mistaken notion that, because the exchange and payments occurred in different years, it was precluded from associating the payments with the exchange. Moreover, whether a stockholder who receives the assets of a corporation in liquidation is subject to transferee liability for the corporate debts presents a reviewable question of law; even assuming that the Tax Court found no connection between the liquidation and the transferee liability, the court below would have been justified in rejecting such a finding.

[14] The Tax Court's failure to find that the losses arose from a sale or exchange, has no significance, contrary to taxpayers' contention (Br. 7, 9), in view of its erroneous belief that it could not associate the loss with the exchange for purposes of determining the nature of the loss. See fn. 13, *supra*. The Tax Court also made no finding that the loss did not arise from a sale or exchange.

sales or exchanges of capital assets are allowable only to the extent provided in Section 117. In substance and effect the post-liquidation payment of a corporate debt by a stockholder in discharge of transferee liability represents a refund of that portion of the corporate assets which was received subject to the debt. It results in an adjustment downward of the previously reported capital gain from the liquidation. *Milliken* v. *Commissioner*, 196 F. 2d 135, 139 (C. A. 2d), petition for certiorari pending, No. 185; cf. *Duveen Brothers, Inc.* v. *Commissioner*, 17 T. C. 124, affirmed *per curiam*, 197 F. 2d 118 (C. A. 2d), petition for certiorari pending, No. 210. See 7 Tax L. Rev. 504 (1952); 30 Taxes, Tax Magazine 443 (1952); 64 Harv. L. Rev. 858 (1951). Stated in terms of the taxing statute, the "amount realized" by the stockholders from the "exchange" of their stock for the corporate assets (Sections 111(a), 115(c)) was reduced by the restoration of a portion of that amount in satisfaction of their transferee liability for the corporate debt; accordingly, they realized and reported a "long-term capital gain" from that exchange in the taxable years in which the liquidation distributions were received (Section 117(a)(4) and (b)), and sustained a "long-term capital loss" from the same exchange in the taxable year in which they relinquished part of the amount received in discharge of their transferee liability (Sections 23(g), 117(a)(5) and (b)).

Had the corporation paid all of its debts before or at the time of distributing its assets in liquidation, the payments would have simply diminished the amount received by the stockholders in exchange for their stock and, correspondingly, the long-term capital gain realized from the exchange. The effect is the same where, as here, the corporation first distributes its assets in liquidation and the stockholders are thereafter required to refund part of the amount received to a creditor of the corporation. In so far as the tax consequences are concerned, it makes no difference whether the liability of the stockholders for the corporate debt is expressly assumed or is imposed upon them by operation of law, or whether the debt was absolute or contingent at the time of liquidation, or whether it was asserted againt the corporation at that time, or whether it is evidenced by a judgment. The important consideration is that the liability of the stockholders for the corporate debt arose directly from the liquidation exchange. *Milliken* v. *Commissioner, supra*; *Duveen Brothers, Inc.*, v. *Commissioner, supra.*[14a] Their post-liquidation pay-

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[14a] In the *Milliken* case, which involved the same question here presented, the court below reaffirmed its decision in this case and stated (196 F. 2d 135, 139):

> Here we are concerned rather with the nature of a loss to determine whether the ordinary loss or the capital loss provision governs. That the taxpayer could not reasonably have expected the expense cannot be permitted to obscure the fact that it was related to, and therefore

ments in discharge of that liability served merely to reduce the amount received (and the capital gain realized) from the exchange, just as if payment of the debt had antedated the exchange or had occurred simultaneously or within the same tax year.

Furthermore, to permit a stockholder to deduct as an ordinary loss the full amount of a corporate debt paid in satisfaction of transferee liability in years after the liquidation would in effect relieve him of tax on more than fifty percent of the capital gain actually realized from the exchange of the stock for the corporate assets, contrary to the mandate of Section 117(b).

An illustration based on the facts of this case will

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viewed practically was a reduction of, a previous capital gain or an increase of a previous capital loss. In the situation of transferee liability this is clearly the case, for by definition such liability stems from the liquidation distribution which, under I. R. C. § 115(c), 26 U. S. C. A. § 115(c), is a capital transaction. Neither the *Switlik* nor the *Bauer* case emphasizes the element of anticipation of the expense, and we find no sanction for it in the statute.

In the *Dwveen* case the Tax Court, in a decision affirmed by the court below on the authority of its decisions in this case and *Milliken*, held that a taxpayer who realized a capital gain from the sale of stock and in a later year was required to make payments to the purchaser in satisfaction of a guarantee, could deduct the payments as capital and not as ordinary losses. The rationale of the Tax Court's decision applies with full force here. While it there purported to distinguish the *Switlik* case, and here regarded that case as indistinguishable, we submit that they all present the same basic question.

bring the problem into sharper focus. Assume that prior to litigation a corporation has $125,000 of assets and $50,000 of liabilities, or net assets of $75,000; that the cost basis of the stock to its sole stockholder is $25,000; and that the stock has been held for more than six months. If the corporation pays its liabilities before distributing its assets in liquidation, or withholds an amount sufficient to pay them, the stockholder will realize a long-term capital gain of $50,000 (the excess of the $75,000 liquidation distribution over the $25,000 cost basis), of which $25,000 (fifty percent of the gain) is taken into account under Section 117(b) in computing net income. On the other hand, if the corporation distributes the assets undiminished by the amount of liabilities to which they are subject, and the stockholder thereafter pays the liabilities and deducts them in full as ordinary losses, the entire taxable gain will be erased. In such case the long-term capital gain on the liquidation will be $100,000 (the excess of the $125,000 liquidation distributions over the $25,00 cost basis, of which $50,000 (fifty percent of the gain) is taken into account under Section 117(b); but this previously reported gain will be entirely offset by the subsequent deduction of a like amount of corporate liabilities as an ordinary loss.[15] If, however, his

[15] In this illustration the entire amount of reported capital gain is eliminated by the subsequent deduction of the corporate liabilities. Whatever figures are used, however, the later

payment of the corporate liabilities of $50,000 is deducted as a capital loss, *i.e.*, only to the extent of $25,000, the result is that the taxpayer pays tax on $25,000, the correct amount of the net taxable gain.

Taxpayers' interpretation of the statute thus produces the incongruous and inequitable result that a capital gain, which would have been realized if the corporate liabilities had been satisfied prior to or at the time of liquidation, is reduced or (as in the illustration) entirely wiped out, if the transferee-stockholder pays the liabilities in a later year. Taxpayers argue, in effect, that Congress has afforded a ready means of tax avoidance by stockholders of a closely held corporation whose assets are subject to outstanding or contingent liabilities at the time of liquidation, especially in a case where as here the stockholders are aware of the liabilities at that time. Nothing in the statute or its legislative history suggests that such was the purpose of Congress. The Commissioner's interpretation, on the other hand, accomplishes a result that is both fair and in harmony with the terms and the general scheme of the statute. By according to the post-liquidation payment of the corporate liabilities the same capital status as the liquidation distributions received from the corpora-

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deduction of the corporate liabilities as an ordinary loss will result in reducing the previously reported long-term capital gain by the amount of the liabilities.

tion, the percentage of the capital gain which must be taken into account under Section 117(b) remains constant whether the corporate liabilities are satisfied by the corporation or by the transferee stockholders, and whether they are paid before or after the corporate assets are distributed in liquidation.

The problem here is strikingly analogous to that presented in *United States* v. *Benedict*, 338 U. S. 692, where a trust took into account under Section 117(b) only fifty percent of capital gains in computing its taxable net income, and sought to deduct in full a charitable contribution made from such gains. This Court held that only fifty per cent of the charitable contribution—the proportionate part attributable to the taxable part of the capital gains—could be deducted. It stated (pp. 697-698) that to permit the deduction in full—

> would result in taxing the capital gains at substantially less than 50% of the amount at which they would be taxed if they were ordinary income. To the extent that the amount subject to tax goes below that percentage, it fails to give effect to the purpose of § 117 (b).

To sanction the deduction of the payments here involved as ordinary losses would likewise frustrate the purpose of Section 117(b), since it would result in taxing a capital gain at less than the percentage prescribed in that section.

D. The Losses Were Not Transformed from Capital Into Ordinary Losses Merely Because They Were Sustained in a Year Subsequent to the Liquidation Exchange

Had the payments in question been made in the same taxable year in which the liquidation distributions were received, they clearly would not have been deductible as ordinary losses. They would merely have reduced the capital gain realized by taxpayers in that year from the exchange of their stock for the corporate assets. The Tax Court assumed that because the payments were made in a year subsequent to the exchange, they must under the annual accounting rule be divorced from the capital transaction to which they are attributable and be allowed as ordinary losses.[16] In so assuming the Tax Court manifestly misconceived the meaning and purpose of the annual accounting rule.

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[16] Prior to *North American Oil* v. *Burnet*, 286 U. S. 417, the Tax Court had held that the payment of transferee liability in a later year required reopening of the stockholder's tax return and recomputation of his tax liability for the year in which the capital gain was reported. *Barker* v. *Commissioner*, 3 B. T. A. 1180; *O'Neal* v. *Commissioner*, 18 B. T. A. 1036. In *North American Oil* (and again in *United States* v. *Lewis*, 340 U. S. 590) this Court held that a taxpayer who receives income under a claim of right, and in a later year is required to restore part of it, may not reopen his return for the earlier year but may deduct the amount repaid in the year of repayment. Although the question here presented—whether the payment is deductible in the later year as an ordinary or capital loss—was not there involved, the Tax Court in the *Switlik* case, which it here followed (R. 8), considered itself precluded by the *North American Oil* decision from examining that question.

That rule is a sound and established one, and the Commissioner's position in this case is in no way inconsistent or out of harmony with the rationale of the annual accounting rule. Under our system of computing net income by annual accounting periods, taxpayers' returns for the years (1937-1940) in which they received the liquidation distributions under a claim of right may not be reopened to reflect the fact that in a later year (1944) they were required to restore a portion of the amounts received to a creditor of the corporation in satisfaction of transferee liability, nor has the Commissioner sought to reopen the earlier year's returns. The excessive amount received in the earlier years and refunded in the later year is deductible as a loss only in the year of repayment. *United States v. Lewis*, 340 U. S. 590; *North American Oil v. Burnet*, 286 U. S. 417. But the fact that the repayment is deductible in the later year does not determine whether it is deductible as an ordinary or a capital loss. The critical fact remains that the repayment discharged a transferee liability which flowed directly from a capital transaction, and hence was deductible in the year of repayment as a capital loss. As the court below stated (R. 20), the principle that each taxable year is a separate unit for tax accounting purposes and that a previous year's return may not be reopened to reflect later events—

> does not mean that an examination of the previous year's return may not be made in

> order to determine the nature of the new fact for the purpose of ascertaining how a gain or loss is to be categorized in computing taxable income for the year in which the new fact happened. So here, considering together the events of the previous year and of the taxable year, the loss in the taxable year show[s] up as arising out of a "sale or exchange."

Indeed here, if we accept the logical consequences of taxpayers' contention that their payment of the corporation's liabilities cannot be associated with the earlier distribution of the corporate assets to them, the paradoxical result would be, as will appear, *infra*, pp. 36-37, that the payments made by taxpayers could not be deducted at all, either as an ordinary or a capital loss.

The annual accounting concept requires that net income be computed and reported on the basis of a "fixed accounting period" known as a "taxable year"; it is designed to "produce revenue ascertainable, and payable to the government, at regular intervals". *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 363, 365. See also *Security Mills Co.* v. *Commissioner*, 321 U. S. 281; *United States* v. *Lewis, supra; North American Oil* v. *Burnet, supra;* Internal Revenue Code, Sections 41, 42, 43 and 48. The concept has reference to *when* (the "taxable year") an income or deduction item must be accounted for in computing taxable net income, not to whether or how the item enters into the com-

putation.[9] Accordingly, taxpayers accounting on the "cash" system must report income and deduct items in the respective taxable years in which they are received and paid; while those accounting on the "accrual" basis must report the items in the respective years in which the right to receive, or the obligation to pay, becomes fixed. "The uniform result has been denial both to Government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount." *Security Mills Co.* v. *Commissioner, supra,* pp. 286-287. But nothing in the annual accounting rule or its rationale forecloses an examination of events of a prior year in order to determine the character and tax effect of a receipt or payment in the current year. *Burnet* v. *Logan,* 283 U. S. 404; *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231; *Milliken* v. *Commissioner, supra; Duveen Brothers, Inc.* v. *Commissioner, supra; Commissioner* v. *Carter,* 170 F. 2d 911 (C. A. 2d); *Westover* v. *Smith,* [illegible] F. 2d 90 (C. A. 9th); *Winter Realty & Const. Co.* v. *Commissioner,* 149 F. 2d 567, 571 (C. A. 2d), certiorari denied, 326 U. S. 754; *Nichol* v. *United States,* 48 F. Supp. 662 (C. Cls.); *Megargel* v. *Commissioner,* 3 T. C. 238; 64 Harv. L. Rev. 858 (1951); 7 Tax L. Rev. 504 (1952); 30 Taxes, Tax Magazine 443

(1952); 38 A. B. A. J. 245 (1952). Cf. *Osenbach* v. *Commissioner* (C. A. 4th), decided July 24, 1952 (1952 P-H, par. 72553).[17] As Judge Learned Hand stated in the *Winter Realty & Const. Co.* case, *supra* (p. 571), "We agree of course, that the tax for every year must be separately assessed; but that does not mean that in computing the tax we may not look to what has happened in earlier

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[17] In the *Osenbach* case there was a liquidation, pursuant to the stockholders' election, under Section 112 (b)(7) of the Code, which provides that out of the total amount of the gain realized on a distribution in complete liquidation, only that part of the gain shall be recognized, *i.e.*, be taxed, as represents accumulated earnings and profits, plus the money and stock and securities (acquired after a specified basic date) distributed in the liquidation. The liquidating corporation had no accumulated earnings and profits and distributed no money or stock and securities, with the results that none of the gain realized by the stockholders on the liquidation was taxable. There was no provision for taxing it at any other time, except insofar as it might be subjected to tax indirectly by reason of the fact that the basis for the assets acquired was required to take the basis of the stock surrendered in the liquidation unadjusted by the amount of gain on the exchange. The only question was whether the amount collected on claims received in the liquidation, the gain on receipt of which was entirely tax-free by virtue of Section 112 (b)(7), was taxable as ordinary income or as capital gain. The court held that it was taxable as ordinary gain since the claims were collected, not sold or exchanged. Unlike the instant case, there was there no payment which resulted in diminishing the gain (or increasing the loss) realized on the distribution in liquidation; thus there was no necessity to relate the amount collected to the gain realized and taxed on the liquidation to determine its nature as there is in respect of the subsequent payments in the present case.

years." It is quite common for a taxpayer to receive or pay amounts in one taxable year as a result of, or as one of several component steps in, a transaction which had its inception in a prior year. To compel the Commissioner and the courts to shut their eyes to the transaction which gives rise to the receipt or payment, merely because the receipt or payment occurs in a later year, would often render it impossible to determine its nature and tax effect. Indeed, by disconnecting the payment from the chain of events which preceded it, the payment is relegated to a statutory vacuum insofar as its tax consequences are concerned. Unless inquiry may be made as to the underlying transaction from which the liability to pay flows, no determination can be made of the character of the payment and its tax significance.[18]

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[18] To take a simple example: A taxpayer contracts to purchase property in 1950, pays the purchase price in 1951, contracts to sell the property in 1952 for an amount exceeding its cost basis, and receives the selling price in 1953. The 1951 payment represents the cost of the property (a nondeductible capital expenditure), which is determinable only by relating the payment to the 1950 purchase. The 1953 receipt represents gain from the sale, includible in gross income only to the extent that it exceeds the cost basis of the property, which is determinable only by reference to the 1950 purchase, the 1951 cost, and 1952 sale. And whether the 1953 gain represents ordinary income or capital gain (and if capital gain, whether it is long-term or short-term) depends on whether the property was a capital asset and was held for more than six months prior to the sale, which are similarly determinable only by reference to the prior years' events.

Thus where stockholders receive liquidation distributions in successive taxable years the courts have treated the several distributions as interrelated parts of a single capital transaction, and accordingly have held that the future years' receipts represent additional capital gain rather than ordinary income. *Commissioner* v. *Carter, supra; Westover* v. *Smith, supra;* cf. *Burnet* v. *Logan, supra.*[19] No reason appears, and none is suggested by taxpayers, for treating the refund of an earlier year's capital receipts—the converse situation—as a separate transaction producing ordinary rather than a capital loss. If the liquidation is a continuing capital transaction where additional amounts are received by the stockholder in a later year, it ought not be regarded as a closed transaction where a part of the amount received is restored in a later year; by the same token, if additional receipts in a later year are includible in that year's income as capital gain, refund payments in a later year ought be deductible from that year's income as a capital loss. See 7 Tax L. Rev. 504 (1952); 30 Taxes, Tax Magazine 443 (1952).

The decision below is not, as taxpayers charge, inconsistent with *Dobson* v. *Commissioner*, 320

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[19] In the instant case the liquidation distributions were received over several years (R. 5), and were reported and allowed in each year as capital distributions (R. 6). Yet it is only by relating the amounts received in each year to the original liquidation exchange that the distributions could properly be so treated.

U. S. 489, rehearing denied, 321 U. S. 231. On the contrary, the court below applied the very reasoning employed in that case in holding that the payments made in the taxable year represented capital losses. In the *Dobson* case purchasers of stock resold it at a loss, and in a later year recovered damages from the seller for breach of the sales contract. The Tax Court held that the purchasers realized no taxable gain in the later year, because the amount recovered was not sufficient to restore their original capital investment in the stock. The Court of Appeals reversed on the ground that the later year's recovery was a transaction separate and distinct from the earlier year's sale of the stock. This Court agreed with the Tax Court,[20] stating (pp. 493, 502-503):

> The Tax Court has not attempted to revise liability for earlier years * * *. It went to prior years only to determine the nature of the re-

[20] Upon petition for rehearing filed by two of the purchasers, whose recoveries were found by both lower courts to represent taxable income, this Court declined to hold as a matter of law that the recoveries constituted proceeds of a "sale or exchange" of a capital asset. 321 U. S. 231. This holding does not, as taxpayers assume, preclude a connection between what is concededly an exchange under Section 115(c) and the payment of transferee liability resulting directly from the exchange. See *Duveen Brothers, Inc., supra; Commissioner* v. *Carter, supra; Westover* v. *Smith, supra;* 64 Harv. L. Rev. 858 (1951). Nor does it detract from this Court's principal holding (320 U. S., at 493) that examination of a prior year's events may be made "to determine the nature of the recovery" (or a payment) in the later year.

> covery, whether return of capital or income. Nor has the Tax Court reopened any closed transaction; it was compelled to determine the very question whether such a recognition of loss had in fact taken place in the prior year as would necessitate calling the recovery in the taxable year income rather than return of capital.
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> * * *
>
> The Government says that "the principal question in this case turns on the application of the settled principle that the single year is the unit of taxation." But the Tax Court was aware of this principle and in no way denied it. Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. * * * The Tax Court analyzed the basis of the litigation which produced the recovery in this case and the obvious fact that "regarding the series of transactions as a whole it is apparent that no gain was actually realized." * * * It concluded that the item should be treated as a return of capital rather than as taxable income.

In this case, however, the Tax Court made no attempt to analyze the nature of the payments in question, in order to determine whether they were deductible as ordinary or capital losses. Applying the theory it had adopted in the *Switlik* case, it held that the annual accounting principle as

a matter of law required their treatment as ordinary losses. In so holding it misapprehended the role which that principle plays in the taxing scheme.

E. If the Payments Are Disassociated from the Liquidation Exchange, They Are Not Deductible at All

If, as taxpayers contend, the payments are not deductible as capital losses under Section 23(g), they would not qualify for deduction as ordinary losses under Section 23(e)(2).[21] That section authorizes the deduction of losses incurred in a "transaction entered into for profit". To come within its provisions it is not enough for a taxpayer to show that the loss falls outside the capital loss provisions. He must affirmatively show that the loss is attributable to a "transaction entered into for profit" other than a sale or exchange of a capital asset.

The record and findings show, and both courts below held, that the payments in question discharged a transferee liability. If, as taxpayers maintain, the payments must be disassociated from the liquidation exchange and the resulting transferee liability, then the only transaction with which they could be associated disappears. And once the prior liquidation exchange and resultant transferee liability are excluded from consideration in deter-

[21] The payments admittedly do not fall within Section 23(e)(1) or (3), which authorizes the deduction of business and casualty losses respectively.

mining the nature of the payments, there exists no basis for treating them either as ordinary losses deductible under Section 23(e) or as capital losses deductible under Section 23(g) since there would be nothing to show that they were incurred in a transaction entered into for profit. Indeed, they would not represent losses at all, but merely voluntary payments by the taxpayers, made without legal obligation, of a debt owed by another. *Sam P. Wallingford G. Corp.* v. *Commissioner,* 74 F. 2d 453 (C. A. 10); *A. Giurlani & Bro.* v. *Commissioner,* 119 F. 2d 852, 857 (C. A. 9); cf. *Welch* v. *Helvering,* 290 U. S. 111.

II.

Bauer's Payment of Half of the Amount of the Judgment Was of the Same Nature, and Is Subject to the Same Capital Loss Limitations, as Pogue's Payment of the Other Half

The judgment which was satisfied by the payments in question was rendered against the corporation and Bauer jointly. *Trounstine* v. *Bauer, Pogue & Co.,* 44 F. Supp. 767 (S. D. N. Y.), affirmed, 144 F. 2d 379 (C. A. 2d), certiorari denied, 323 U. S. 777. By reason of that fact Bauer contends that his payment of half of the amount of the judgment, as distinguished from Pogue's payment of the other half, satisfied a liability other than a transferee liability and consequently must be treated as an ordinary loss. The contention is erected upon a series of unwarranted assumptions.

1. In the first place, the judgment against Bauer was predicated, at least in part, on his liability as a stockholder-transferee of the corporation. The suit which resulted in the judgment was for an accounting of the profits of a joint venture relating to the sale of securities, entered into by the corporation and the plaintiff. Bauer and Pogue were made parties defendant as stockholders and directors of the corporation, but Pogue was not served and did not appear. 44 F. Supp., at p. 769. The District Court found that "Part of the assets of the corporation have been distributed to Bauer and Pogue, and its remaining assets still remain undistributed", *ibid.*, p. 769;[22] and that "In the distribution of the assets of the corporation, in which he [Bauer] undoubtedly shared, he has personally profited from the violation of the joint trading account agreement and was a party to such violation". *Id.*, p. 773. It held that Bauer "should, accordingly, be held jointly liable with the corporation". *Id.*, p. 773. The Court of Appeals agreed, holding that Bauer was "Jointly and severally liable with the corporate defendant". 144 F. 2d, at p. 382. Thus the judgment as against Bauer was based on the transfer to him of the corporate as-

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[22] It has here been stipulated that the liquidation distributions began before the action was started, continued while it was pending, and were completed before the judgment became final; and that Bauer and Pogue each received distributions exceeding one-half of the amount of the judgment. (R. 17-18.)

sets, including the joint venture profits for which the corporation had failed to account, as well as on the fact that as president and co-owner he mismanaged the corporation.

By paying only one-half of the judgment, Bauer himself recognized that it was based on his liability as a transferee of the corporate assets. If, as he now suggests (Br. 17-18), the judgment as against him was founded principally on a different liability, he would have been obliged to pay its full amount, since no similar judgment was rendered against Pogue. Yet he and Pogue each paid one-half of the judgment, which corresponded with their former stock interests and their pro rata transferee liability. Bauer thus chose which liability he would satisfy, to his own advantage, and he cannot now be heard to say that he paid a different liability. Significantly, the Tax Court saw no difference in nature or tax effect between the payments made by Bauer and Pogue. It found that "each" of them "was required to, and did, pay one-half of the judgment" (R. 6) as "transferees" of the corporation (R. 6, 8). The court below likewise regarded Bauer's payment as basically "no different from that of the other transferee". (R. 20.)

In short, the suit was primarily one against the corporation for an accounting of the profits derived by it from a joint venture, and the liability of Bauer and Pogue as transferee-stockholders was

secondary to that of the corporation. Had the corporation complied with its agreement and accounted for the profits before distributing them in liquidation, neither Bauer nor Pogue would have received the excessive liquidation distributions which they were later required to restore to the judgment creditor of the corporation.

2. Secondly, while the judgment against Bauer was apparently also based on his misconduct as an officer of the corporation, it hardly would follow that his payment of one-half of the judgment is therefore deductible as an ordinary loss under Section 23(e), even if it were assumed *arguendo* that his payment was to satisfy partly his liability for misconduct. Even if the loss be viewed in this light, it was not incurred in his "trade or business" within the meaning of Section 23(e)(1); nor was it incurred in a "transaction entered into for profit" within the meaning of Section 23(e)(2), because the joint venture transaction which he mismanaged as an officer was entered into on behalf of and for the profit of the corporation, not for his own profit, and it was not incurred in *his* "trade or business". Even assuming, therefore, that Bauer was held jointly liable with the corporation solely because of his mismanagement of its affairs, his payment of one-half of the judgment would not be deductible by him as a loss at all, either as an ordinary or as a capital loss. Cf. *Stuart* v. *Commissioner*, 84 F. 2d 368 (C. A. 1st), certiorari

denied, 299 U. S. 575; *Reimold* v. *Commissioner*, 144 F. 2d 390 (C. A. 3d); *Clark* v. *Kavanagh*, 152 F. 2d 49 (C. A. 6th); *Hickey* v. *Chahoon*, 153 F. 2d 107 (C. A. 2d), certiorari denied, 328 U. S. 843; *Wigton* v. *Commissioner*, 13 T. C. 323; also cf. *Commissioner* v. *Heide*, 165 F. 2d 699 (C. A. 2d).[23]

3. Thirdly, whether or not Bauer had been joined as a party-defendant in the ~~action~~ against the corporation, he and Pogue would have been jointly and severally obliged as transferees of the corporate assets to satisfy the judgment against the corporation to the extent of the amounts they respectively received, and they each admittedly received an amount exceeding one-half of the judgment. (R. 5-6.) The most that may be said in Bauer's favor, therefore, is that his payment of one-half of the judgment served to extinguish *in toto* his transferee liability as a stockholder and *pro tanto* his tort liability as an officer. Since his payment of half of the judgment extinguished his pro rata transferee liability, it was in substance and for tax purposes no different from Pogue's payment of the other half and, like Pogue's pay-

[23] Even if Bauer's payment could be viewed as a loss arising from a joint venture entered into individually for his own profit, instead of from one entered into as agent of the corporation for the profit of the corporation, it still would not follow that the payment would be deductible as an ordinary rather than a capital loss. The joint venture was engaged in the sale of securities—capital transactions resulting in capital gains—and since the judgment was for an accounting of the gains, its satisfaction represented a capital loss.

ment, it is deductible as a capital loss. As the court below stated (R. 20):

> Here, however, Bauer was also liable, as a transferee, for the amount paid out, and that liability (we have held above) was an integral part of the original liquidation transfer, and so deductible as a capital loss only. We think, therefore, that the accidental fact that Bauer was liable both as an officer and as a transferee, did not give him the option of picking which liability he would satisfy, according to its tax consequences, when, as here, satisfaction of one liability discharged the other. For our purposes, the fact that he was personally liable for the judgment is superfluous; his fundamental position in regard to the 1944 payment was no different from that of the other transferee.

This reasoning is particularly persuasive, here, since there is nothing in the record to indicate that Bauer's payment was made with funds other than those transferred to him by the corporation. Indeed, there is no suggestion that at the time of the payment Bauer owned any assets other than those received upon liquidation of the corporation. He is scarcely in a position, therefore, to urge that his payment did not satisfy his transferee liability.

4. In any event, the Tax Court did not reach or pass upon the question of whether Bauer's payment should be treated differently from Pogue's. Viewing both payments as made in satisfaction of

transferee liability, it treated this case as presenting the same issue as the *Switlik* case. (R. 8.) The court below likewise viewed the two payments as essentially the same, and likewise treated this case as presenting the same issue as *Switlik.*[24] (R. 19.) Should this Court disagree with the holding of both courts below that Bauer's payment is in the same category as Pogue's for purposes of testing its deductibility, the case should be remanded to the Tax Court for a determination of whether and to what extent Bauer's payment, as distinguished from Pogue's, is deductible as either an ordinary or capital loss.

CONCLUSION

The judgment of the Court of Appeals is correct and should be affirmed.

Respectfully submitted,

ROBERT L. STERN,
Acting Solicitor General.

CHARLES S. LYON,
Assistant Attorney General.

PHILIP ELMAN,
ELLIS N. SLACK,
HELEN GOODNER,
HARRY BAUM,
Special Assistants to the Attorney General.

OCTOBER, 1952

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[24] The petition for a writ of certiorari in this case asserted direct conflict with the *Switlik* case, and because of the conflict the Commissioner did not oppose the granting of the writ.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

* * *

(e) *Distributions by Corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in section 115.

(f) *Determination of Gain or Loss.*—In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in section 111.

* * *

(26 U. S. C. 1946 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business;

* * *

(g) *Capital Losses.*—

(1) *Limitation.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117.

* * *

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

* * *

(26 U. S. C. 1946 ed., Sec. 111.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * *

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. * * *

* * *

(26 U. S. C. 1946 ed., Sec. 115.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) [As amended by Sec. 150(a)(1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include * * *

* * *

(4) *Long-Term Capital Gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

(5) *Long-Term Capital Loss.*—The term "long-term capital loss" means loss from the sale or exchange of a capital asset held for more than 6 months, ~~if~~ and to the extent such loss is taken into account in computing net income;

* * *

(b) [As amended by Sec. 150(c), Revenue Act of 1942, *supra*] *Percentage Taken into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

* * *

(d) [As amended by Sec. 150(c) of the Revenue Act of 1942, *supra*] *Limitation on Capital Losses.*—

* * *

(2) *Other Taxpayers.*—In the case of a taxpayer, other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus the net income of the taxpayer or $1,000, whichever is smaller. * * *

* * *

(26 U. S. C. 1946 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Revenue Code:

Sec. 29.23(e)-1. *Losses by Individuals.*—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise are fully deductible if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck, or other casualty, or theft, and a deduction therefor has not prior to the filing of the return been claimed for estate tax purposes in the estate tax return, or (d) if not prohibited or limited by any of the following sections of the Internal Revenue Code: Sections 23(g) and 117, relating to capital losses; * * *

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Sec. 29.23(g)-1. *Capital Losses.*—Section 23(g) provides in effect that deductions allowed to individuals under section 23(e) and to corporations under section 23(f) for losses sustained on the sale or exchange of a capital asset shall be limited in amount to the extent provided in section 117. * * *

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Sec. 29.115-5. *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in exchange for the stock so canceled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and section 29.111-1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112, and shall be subject to the conditions and limitations provided in section 117.

* * *

The provisions of this section may be illustrated by the following examples:

Example (1). A, an individual who makes his income tax returns on the calendar year basis, owns 20 shares of stock of the P Corporation, a domestic corporation, 10 shares of which were acquired in 1931 at a cost of $1,500, and the remainder of 10 shares in December 1941 at a cost of $2,900. He receives in April

1942 a distribution of $250 per share in complete liquidation, or $2,500 on the 10 shares acquired in 1931, and $2,500 on the 10 shares acquired in December 1941. The gain of $1,000 on the shares acquired in 1931 should be included in A's gross income to the extent of 50 percent, or $500; the loss of $400 on the shares acquired in 1941 should be deducted in computing A's net income to the extent of 100 percent, or $400. (See section 117.)

* * *

Sec. 29.117-2. *Percentage of Capital Gain or Loss Taken Into Account: Net Loss Carry-Over.* (a) *General.*—In computing the net income of a taxpayer, other than a corporation, the amount of the gain or loss, computed under section 111 and recognized under section 112, upon the sale or exchange of a capital asset shall be taken into account only to the extent provided in section 117(b). The percentage of the gain or loss to be taken into account ranges from 100 percent to 50 percent, depending upon the period for which the asset was held. * * *

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